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September 1, 1983

CABINET COUNCIL ON ECONOMIC AFFAIRS
WORKING GROUP ON UNITARY TAXATION

OPTIONS PAPER

I. Introduction

At its mid-July meeting, the Cabinet Council on Economic Affairs established a Working Group to identify the federal and state government interests in the worldwide unitary taxation method and to develop possible legislative options. This paper responds to that mandate. Procedural options describing and evaluating how to seek implementation of an Administration decision on worldwide unitary taxation are discussed in Appendix A. In addition to worldwide unitary taxation, the paper also considers, in Appendix B, the issues associated with state corporate taxation of dividends received from a foreign corporation.

The Working Group has been advised by the Solicitor General that the Government has until the week of September 19 to file a possible submission before the Supreme Court in support of Container Corporation's petition for a rehearing. To permit the Solicitor General to file a Government submission sometime during the week of September 19, a CCEA or Presidential final decision on unitary taxation will have to be made by September 21 at the latest.

The issues raised by worldwide unitary taxation are not new. Since 1965, legislation has been introduced almost annually, but never approved by Congress, to conform state to federal practice, most recently in the 98th Congress by Senator Mathias as S. 1225 and by Representative Conable as H.R. 2918. Further, a provision in the 1977 proposed United States-United Kingdom income tax treaty would have prohibited application of the worldwide unitary method by a state to affiliates of U.K. parent corporations and their related foreign subsidiaries. This provision was not approved by the U.S. Senate when it ratified the treaty in 1978.

In a June 27, 1983 decision in Container Corporation of America v. Franchise Tax Board, the U.S. Supreme Court upheld California's use of the worldwide unitary method of taxation, but only as applied to U.S.-based multinationals. The court stressed that its decision was not necessarily determinative of how it would rule in the case of a foreign-owned multinational. The decision was 5-3, with Justice Stevens abstaining. In upholding the worldwide unitary method in the Container case, the Supreme Court held that the worldwide combined unitary method was not unconstitutional. On July 6, the Court summarily dismissed the appeal of Chicago Bridge, a case involving a challenge to Illinois' use of the worldwide unitary method, for "want of a substantial federal question."

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II. Worldwide Unitary Method

A. Description of current practice

When a corporation (or group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are available for making this determination: separate accounting and worldwide unitary combination.

The separate accounting approach calculates the income earned by related corporations by using "arm's-length" prices. That is, flows of goods and services between related or commonly-owned corporations are valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's-length. When the income of a corporation doing business in a state is calculated by this method, a state using the separate accounting method does not look to the income of affiliated corporations not doing business in that state.

The worldwide unitary approach seeks to calculate the in-state income of a "unitary" business operating across national boundaries by applying a unitary apportionment formula to the worldwide income and business activity of a combined group of affiliated firms. Under this approach, income from each affiliated corporation, domestic or foreign, that is part of a unitary business enterprise is combined to determine the income of the entire corporate group. The share of this combined income attributable to the particular state is calculated by the amount of business activity in the state relative to the corporate group's worldwide business activity. Business activity usually is measured by a formula that includes relative amounts of payroll, property, and sales.

While many states use formula apportionment to determine the in-state income of a single corporation that operates in more than one taxing jurisdiction, this paper addresses the state practice of applying the unitary method with respect to the combined income of an affiliated group of corporations which includes foreign affiliates not doing business in the state (referred to as the worldwide unitary method). Approximately 13 of the 45 states that impose a corporate income tax use the worldwide unitary method, rather than separate accounting. A larger number of states, about 27, apply the unitary method to a combined group of exclusively domestic corporations forming a unitary business. Only 15 of these 27 states, however, use domestic combination on a regular basis.

There is no clear standard that provides policymakers a single answer as to the unambiguously correct amount of income a state should be allowed to tax. Because of the absence of such a

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benchmark, it is impossible to conclude that either method, separate accounting or worldwide unitary, necessarily mismeasures taxable income. The Supreme Court recognized this in Container in stating that "both geographical apportionment and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory."

B. Federal interest

The federal interest in this issue involves: (a) minimizing double taxation so as to improve the U.S. investment climate and promote the free flow of international investment, and (b) abiding by a consistent set of international tax rules (which the United States has been a world leader in developing) in order to eliminate obstacles to investment and to protect U.S. corporations from objectionable actions by foreign governments, including retaliatory action. It may be impossible, however, to eliminate double taxation totally since that would require the perfect meshing of divergent tax systems developed by different political jurisdictions. Similarly, the objective of a coherent U.S. international economic policy may be frustrated by the fact that our network of bilateral tax treaties does not apply to the states. These treaties are an important tool for alleviating double taxation and securing adherence to a common set of tax rules and procedures.

C. State interest

Against this national interest must be set the states' interest in the continued use of worldwide combined reporting. The states argue that they: (a) should be able to determine their own fiscal structure free of federal interference; (b) would suffer large revenue losses from federal restrictions because of artificial profit shifting by multinationals; and (c) cannot administer a system based on separate accounting and arm's-length principles because of the lack of an objective standard for the determination of income on an arm's-length basis. The fiscal sovereignty view was articulated recently by the Supreme Court in its Container decision. "We have long held that the Constitution imposes no single formula on the States." The states also contend that any tendencies by individual states toward an "unreasonable" tax system will be corrected in the marketplace without federal intervention as the offending states eventually lose investment to competing states. Illinois, for example, recently adopted legislation rejecting worldwide, but not domestic, unitary combination. In approving the legislation, the governor stated that he thought it would enhance the Illinois business climate.

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D. Policy options

The Working Group has identified, and considered, four options: retention of present state practice, prohibiting worldwide combination, prohibiting worldwide combination only of foreign-based multinationals, and permitting worldwide combination subject to federal minimum standards to prevent unreasonable allocations of income. Each is discussed in more detail below.

1. Option One: Retain present state unitary taxation practices. Under this option, no federal restrictions would be imposed on the states. The states would be permitted to continue to apply the unitary method on a worldwide basis.

ADVANTAGES

(a) Respects state sovereignty. While Governor of California, Ronald Reagan enunciated this principle in a 1967 letter to former Congressman Hanna: "Federal intervention into state tax matters is objectionable in principle." Governor Reagan expressed this view in the context of commenting on the Interstate Taxation Act, a legislative proposal to provide some federal uniformity in state taxes. In a federal system of government, states should be given wide latitude to design their own fiscal systems. This view has been forcefully articulated by the Supreme Court, which has only rarely struck down state income tax systems on constitutional grounds.

(b) Reflects historical Congressional reluctance to act. Although the Supreme Court frequently has invited Congress to correct any perceived faults in state income tax systems, Congress has not done so. Hearings were held in 1980 on the Mathias-Conable legislation, which would restrict the worldwide use of the unitary method and limit state corporate taxation of dividends received from a foreign corporation; however, the legislation was not the subject of a vote in either the House or the Senate. Apart from legislating some modest nexus rules clarifying when a state could impose an income tax and providing some rules for the taxation of financial institutions and state instrumentalities, Congress has been silent on this issue. In the current Congress, there is strong opposition to the Mathias-Conable legislation.

(c) Protects state revenues. The principal theme of President Reagan's first State of the Union Address was New Federalism. Returning power, authority, and revenue sources to the states is still central to the Administration's program. Unreasonable restrictions on state taxation would be in open conflict with that federalism initiative. According to a survey compiled by the Multistate Tax Commission in response to a Treasury Department questionnaire, enactment of the unitary portion of Mathias-Conable would reduce state tax revenues by about

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$625 million annually, or 5 percent of total state corporate tax collections. (This does not include the $95 million which Florida claims it will raise from its recent adoption of the worldwide unitary method.) The states deny that this revenue loss is a consequence of taxing foreign source income, or that it can be viewed as double taxation. Rather, they contend there is no way to measure the income earned by individual corporations that are members of a unitary group of affiliated corporations accurately, that separate accounting is subject to artificial profit shifting through transfer price manipulation, and that unitary combination is the only way to determine a state's rightful share of the income earned by a unitary group of affiliated domestic and foreign corporations.

(d) Easier to administer. The states contend that they have neither the resources nor the ability to verify the multitude of related party transfer prices that the separate accounting method demands. In short, they view the unitary method as a mechanical, but objective, method of providing a solution to an apportionment problem with respect to which all agree that there is no single correct solution. They note, for example, that a group of affiliated corporations can reduce its costs through the advantages of economies of scale, central advertising, quantity discounts, and ready access to capital markets. The unitary method looks at the group as a single entity, thus cutting across the legal veil of corporate charters.

(e) Uncertain foreign impact. While foreign governments have objected to state use of the unitary method on a worldwide basis, it is not yet clear that there is force and substance to those complaints. A recent Advisory Commission on Intergovernmental Relations (ACIR) study concluded "there is no evidence that [current] state tax practices cause harm to the nation." In evaluating the consequences of state use of the worldwide unitary method, the study found no adverse impact on foreign investment in the United States, no refusal by foreign governments to conclude treaties with the United States, and no retaliatory action.

DISADVANTAGES

(a) Objections from foreign governments. Belgium, Canada, France, Greece, Japan, the Netherlands, Switzerland, the United Kingdom, and the European Economic Community have objected to the U.S. government over the application by the states of the worldwide unitary method to foreign-owned multinational groups. These countries, which host significant amounts of investment from the United States and which also are important sources of foreign investment in the United States, argue that the states are appropriating an unreasonable proportion of the profits from foreign investment to the United States and, in the case of the United Kingdom, have threatened retaliation. The Netherlands

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also has asserted that this method of taxation is a violation of our Treaty of Friendship, Commerce, and Navigation (FCN) and may take the matter to the International Court of Justice (ICJ). The United States has FCNs containing similar language on taxation with 19 other countries, most of which contain provisions allowing either party to bring a dispute under the treaty before the ICJ. The OECD Business and Investment Advisory Committee (BIAC) also has attempted to raise unitary taxation as a national treatment issue in the OECD.

(b) Impact on tax treaties. While its precise effect in a treaty negotiation, which is a series of compromises over a wide range of issues, is difficult to determine, it is possible that, on balance, U.S. negotiators will conclude less favorable bilateral income tax treaties if the unitary problem remains unresolved. Foreign jurisdictions, for example, may no longer be inclined to cover their local taxes in treaties if the United States cannot extend similar coverage on a reciprocal basis.

(c) Double taxation. On a separate accounting basis, foreign operations, because of higher risks and lower labor costs, may be more profitable than U.S. domestic operations. Income that would be considered foreign source under separate accounting is subject to state taxation under the worldwide unitary method. Since the income already has been taxed in the foreign jurisdiction, the unitary method subjects it to double taxation, with no allowance for foreign taxes paid. This option would continue to place U.S. taxpayers subject to worldwide unitary combination at a competitive disadvantage in their dealings abroad with their foreign counterparts not taxed on a unitary basis. A state using the unitary method may tax income that would not be taxable for federal purposes. Under federal rules, the income of a foreign corporation not doing business in the United States is not subject to tax until repatriated as a dividend to its U.S. shareholder. The unitary method, in contrast, may tax income that is earned by a foreign corporation under separate accounting, even before it is paid out as a dividend.

(d) Trade and investment distortions. To the extent that a determination of income under a worldwide unitary method differs from income calculated on a separate accounting basis, it alters the expected rate of return on an investment and is likely to affect the investment decision. Foreign corporations may be unwilling to divulge all the information required under the unitary system due to confidentiality and/or cost considerations. Disinvestment in the United States may occur, or foreign multinational corporations may alter their plans and divert their investment from a preferred location to another state not using the worldwide unitary method. Failure by the U.S. government to act on this issue will be seen by our trading partners as inconsistent with our longstanding commitment to open investment, for which the United States has assumed a leadership role in interna-

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tional fora, and may detract from the spirit of the investment policy statement expected to be announced soon by the White House.

(e) Administrative burden. The worldwide unitary method requires the annual translation of the books of foreign corporations into U.S. accounting concepts and U.S. currency. While U.S.-based multinationals are required to report the activities of their foreign subsidiaries for U.S. tax purposes, foreign-based multinationals would not otherwise be required to report the financial dealings of related foreign corporations on a dollar basis. It also is not obvious that federal restrictions on the unitary method would impose a parallel administrative burden on the states. Rather than be compelled to enforce the arm's-length method on their own, the states could be given access to information used to police separate accounting at the federal level.

(f) Possible retaliation or other "serious national harm." State use of the worldwide unitary method is frequently raised by our developed nation treaty partners as a significant taxation issue that adversely affects multinational corporations headquartered in those countries. In reaction to the Container decision, the Dutch government has indicated its reluctance to conclude a bilateral tax treaty with the United States. Congressional hearings in 1980 identified instances in which foreign investment was not made in California because of the unitary method. These instances may increase if other states follow Florida's lead and respond to Container by also adopting the worldwide unitary method. Under the new Florida law, sales made in jurisdictions without a state corporate income tax, such as Texas or most foreign countries, will be considered Florida sales for purposes of determining Florida's tax base. This aggressive use of the unitary method, specifically designed to increase Florida's tax base, may be a severe irritant to foreign governments and foreign corporations.

The threat of foreign retaliation, which the ACIR study found nonexistent, may become a reality. Since the Container decision, several foreign governments have notified the United States of their continuing concern over the use of the unitary method on a worldwide basis. These countries are "awaiting" the U.S. Government's reaction. An amendment to the 1984 U.K. Finance Bill was recently introduced in the House of Commons to deny certain U.K. tax benefits to U.S. firms domiciled in states using the worldwide unitary method. If their concerns are not assuaged, their frustration may lead them to pursue a retaliatory strategy against the United States.

Another possibility that might cause "serious national harm" is foreign adoption of the worldwide unitary method. The states' argument that the unitary method is needed to counter profit

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shifting by multinationals is similar to the concerns expressed by less developed countries (LDCs). If the LDCs emulate the states and adopt a worldwide system similar to the unitary method, U.S. taxpayers would be required to report their worldwide business dealings in foreign currencies and accounting rules, and perhaps even be forced to divulge confidential information.

2. Option Two: Prohibit worldwide combination. Under this option, worldwide combination would be prohibited both for U.S.- and foreign-based multinationals. States no longer would be permitted to include foreign corporations not doing business in the United States in a combined unitary calculation. By excluding all foreign corporations from the unitary method, it would implement a "water's edge" policy with respect to state taxation.

ADVANTAGES AND DISADVANTAGES

The advantages and disadvantages of this option are the reverse of option 1 and, therefore, are not restated here. It should be noted, however, that if this option is adopted, rather than using the federal adjustments, the states might seek to offset the potential revenue loss through aggressive transfer pricing adjustments of their own.

3. Option Three: Prohibit unitary combination of foreign-controlled groups. This option would disallow worldwide unitary combination only for foreign-controlled corporate groups. Thus, the states could not include foreign parent corporations and their affiliated foreign corporations not doing business in the United States in a combined unitary return. The unitary method would still be permitted for U.S.-controlled groups. On at least two occasions, the Treasury Department has supported this alternative in one form or another. It proposed the U.S.-U.K. treaty in 1977 and supported the unitary restrictions in the Mathias-Conable legislation in 1980, but only as applied to foreign-based multinationals.

ADVANTAGES

(1) Responds to foreign objections. This option would provide foreign governments with a clear, decisive, and acceptable response. The application of the unitary method to foreign-owned multinationals is an acutely sensitive and contentious issue. By addressing the concerns of foreign governments and foreign taxpayers, a significant irritant in international economic relations with a number of other countries would be removed. The Administration would be on record as recognizing, and attempting to solve, a significant foreign policy problem. This action would stand as a tangible expression of the Administration's policy of free and open access to international markets.

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(2) Treaty "bargaining chips." If done by treaty, rather than by legislation, U.S. negotiators would be provided a "bargaining chip" that could be used to extract concessions from other countries. If the foreign objections to the unitary method are real, foreign governments will be willing to give something in exchange for solving this problem. By being able to point to a quid pro quo, the Administration would be able to dilute some of the criticism for supporting any restrictions on the unitary method.

(3) Small revenue loss to states. From the point of view of state revenue losses, eliminating worldwide combination only for foreign-controlled groups involves perhaps 5 to 10 percent of the total revenue loss of prohibiting worldwide combination generally. The states would find this option less objectionable than a blanket exclusion of all foreign corporations. In fact, privately and informally, some representatives of the taxing authorities of several unitary states have indicated a possible willingness to accept it, provided it is coupled with Administration opposition to federal restrictions on the worldwide unitary method as it applies to U.S.-based multinationals.

DISADVANTAGES

(1) Discrimination against U.S. multinationals. This option places U.S.-based multinationals at a competitive disadvantage in dealing with foreign-owned multinationals, even when operating in the United States. In fact, this option might be challenged as an unconstitutional infringement of the due process and equal protection provisions by unreasonably discriminating against U.S.-based multinationals. On political grounds, the Administration would be criticized for tilting what should be a "level playing field" in favor of foreign competition. Dutch-owned Shell Oil, for example, would get relief; Mobil and Exxon would not.

(2) State opposition. Notwithstanding informal representations to the contrary, the states might oppose this option to the extent they view any federal restrictions on their taxing prerogatives as unacceptable. They would criticize this approach for allowing the federal government to get a "foot in the door" that would lead to further federal restrictions. In particular, the states would contend that the next step would be to prohibit the inclusion of foreign corporations owned by U.S. taxpayers in a combined unitary return.

(3) Difficulties in treaty ratification. The treaty avenue may not be successful. As mentioned above, the U.S. Senate rejected this approach in the U.S.-U.K. Treaty. Although a simple majority of the Senate approved the provision, it was rejected because a treaty must be approved by a two-thirds vote

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in the Senate. In addition, the treaty approach would be a piece-meal solution to the problem. Only countries willing to negotiate a treaty with the United States would obtain relief from the unitary method.

4. Option Four: Federal minimum standards for application of the worldwide combined unitary method. Under this option the federal government would recognize the validity of the worldwide unitary method as an acceptable method of state taxation. Notwithstanding this recognition, the interest of the federal government will be asserted to make certain that application of the unitary method does not disrupt international relations or the international economic interests of the United States.

The Treasury Department will develop standards, in consultation with the states, to ensure that the worldwide unitary method is applied in a manner which does not unreasonably allocate worldwide income (including foreign dividends) to the states or impose excessive administrative burdens on taxpayers. These standards would include the development of a uniform definition of a "unitary business" and uniform standards to minimize administrative burdens. In addition, the Treasury Department would examine the operation of the three factor apportionment formula in an international context and determine whether adjustments in the formula are appropriate.

The Federal standards, which would be binding on the states, would not prescribe taxing rules that all states would be required to adopt. Rather, they would be limitations designed to prevent such serious misallocations of worldwide income by the states as would be harmful to the national interest. For example, the standards would prevent state taxation of income of foreign members of a corporate group if the assertion of a unitary business is based solely on common ownership, where no other economic relationship or institutional interaction among the corporations exists. However, the standards would permit the application of the worldwide unitary method where a unitary business is evidenced by common ownership, a movement of goods and services between foreign and domestic affiliates, and by common management and financing. Legislation could be required under this option if states refuse to follow such standards for the application of the worldwide unitary method.

ADVANTAGES

(1) Compromise Approach. This option represents a compromise between competing state interests and federal international tax, investment and trade interests.

(2) Avoids possible overreaction to problem. The Administration would not be forced to act in haste on problems (extraterritorial taxation, undue administrative burden) that are said to exist but that have not been adequately documented as a general pattern.

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DISADVANTAGES

(1) Will not fully satisfy interested parties. Foreign governments and multinationals will argue it does not resolve the issue. Indeed, foreign governments in particular may feel it necessary to increase pressure and perhaps invoke retaliatory measures.

While states will be pleased with federal recognition of the validity of the worldwide unitary method, they may object to federal intervention in the application of the method.

(2) Delays final resolution. This option requires continued review of the unitary tax issue as minimum standards are developed. It may be impossible to reach a consensus between the states and multinational corporations as to an acceptable approach to unitary taxation. It also may be very difficult to obtain Congressional support for federal minimum standards, should legislation be necessary.

III. Concluding Comments

This is a classic "no win" issue for the Administration. There is no way to satisfy all parties: the states, foreign governments, and multinational taxpayers, both U.S. and foreign. The Administration will be vocally criticized for whatever decision it makes.

On the one hand, retention of state practice would appease the states, but the concerns of foreign governments and the business community will continue unabated. They would argue that the federal government was indifferent to a system of taxation that is creating foreign policy problems, interfering with the free flow of investment, and subjecting U.S. business to possible foreign retaliation.

On the other hand, any federal restrictions will be opposed by the states as an infringement of their fiscal sovereignty and a violation of the principles underlying the President's call for his "New Federalism" program.

Congress is aware of the sensitivity of this issue and, despite repeated invitations by the Supreme Court, has declined to impose federal restrictions on state taxation practices. Although the Treasury Department supported some facets of the Mathias-Conable legislation in 1980, neither the House nor the Senate voted on the bill. As in past years, the chances for any legislation restricting state taxation appear dim. Supporting immediate federal legislative or judicial initiatives may present the Administration with the "worst of both worlds"; it will be criticized for supporting legislation that, with an election year on the horizon, Congress has no appetite for passing.

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APPENDIX A

PROCEDURAL OPTIONS

The four options discussed in the paper are: retain present state tax practices; prohibit worldwide unitary combination; prohibit combination only for foreign-controlled unitary groups; and permit worldwide combination subject to federal minimum standards to prevent unreasonable allocations of income. They could be implemented in a variety of ways. This appendix identifies and evaluates the procedural aspects of those alternatives.

I. Option One: Retain present state unitary taxation practices.

The Administration could implement this option by doing nothing. It would simply not support any legislative or judicial initiatives aimed at restricting state use of the worldwide unitary method. It could reserve future policy latitude for its itself by qualifying any statement it did make. It could say, for example, that "at this time" it has concluded that federal restrictions are unnecessary.

II. Option Two: Prohibit worldwide combination.

The Administration could seek to implement this option by supporting restrictions on the worldwide unitary method in the courts and/or in Congress.

A. Judicial avenue

The Government could file a submission before the Supreme Court in support of Container Corporation's petition for rehearing.

ADVANTAGES

1. Would enable the Government to avoid attacking the unitary method on policy grounds; rather it would assert it violated the foreign commerce clause in the constitution.

2. Would rebut the suggestion in the Container Corporation decision that the United States no longer stands by the position it took in the Chicago Bridge and Iron Company case.

3. Would send a positive signal on unitary taxation to our major trading partners, and might provide further breathing room in terms of foreign complaints, and risk of retaliation.

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DISADVANTAGES

1. If the Government files a submission in Container and if Container Corporation's petition for rehearing is denied, the denial will be interpreted by the states as a rejection by the Court of the constitutional relevance of a federal interest. That is, the states will advertise that they have won a significant constitutional victory, although the denial may actually represent only a decision by the Court not to hear the Container case again. (It is likely that the petition for rehearing will be denied. Although the Court professed uncertainty in its Container decision as to the federal government's views of the unitary method, the Solicitor General's office believes the Court fully understood the government's views as set forth in Chicago Bridge.)

2. Filing a submission, but not supporting a legislative remedy, risks immediate and strong negative reaction from the states, without making much progress toward resolving the problem.

3. The Container case involves a U.S.-based multinational. If the Administration decides it only wants to remedy the foreign parent problem, it may be preferable to wait until the Supreme Court accepts jurisdiction in such a case.

B. Legislative avenue

The Administration could support Mathias-Conable, or perhaps its own legislative initiative aimed at restricting the worldwide unitary method.

ADVANTAGES

1. Offers promise of resolving the problem; the Supreme Court has been very reluctant to find state tax systems defective on constitutional grounds.

2. Would be viewed as decisive Administration action to solve the problem. For over a year the Administration has publicly said it would do nothing until the Supreme Court decided the unitary cases before it. Because of the delay and uncertainty associated with Court proceedings, supporting judicial, but not legislative, relief would be seen as a stalling tactic.

DISADVANTAGES

1. Would create vociferous state opposition. While the states might be able to differentiate that a court filing is based solely on a constitutional challenge, legislative support will be viewed as an unvarnished policy attack on the unitary method.

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2. May be unsuccessful. Congress has shown no more appetite than the Supreme Court for addressing this issue.

III. Option Three: Prohibit unitary combination of foreign-controlled groups.

The Administration could seek to implement this option judicially or legislatively; the procedural pros and cons are similar to option 2. Alternatively, it could attempt to include a restrictive unitary provision in bilateral tax treaties.

A. and B. Judicial and Legislative avenues

(see Option Two above)

C. Treaty avenue

ADVANTAGES

1. May enable the United States to obtain foreign concessions for resolving the unitary problem.

2. Because it is country-by-country and only addresses the foreign parent case, may be less threatening to the states.

DISADVANTAGES

1. Would be a piece-meal solution that would take considerable time to implement. Countries with which we are not prepared to negotiate a treaty in the near future would still complain about the unitary method.

2. Was rejected by the U.S. Senate in the U.S.-U.K. treaty.

IV. Option Four: Federal minimum standards for application of the worldwide combined unitary method.

Adoptions of this option would call for the following actions on the part of the Administration:

A. No participation in the Container Corporation case,

B. No support for the Mathias-Conable legislation, and

C. The development, in consultation with the states, of binding federal minimum standards for the application of the worldwide unitary tax method by the states. This process may take considerable time, and may or may not require eventual federal legislation.

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APPENDIX B

DIVIDENDS PAID BY A FOREIGN CORPORATION

The Administration may also wish to consider what federal restrictions, if any, should be imposed on state corporate income taxation of dividends paid by a foreign corporation. The Mathias-Conable legislation, for example, generally would permit state taxation of such dividends only to the extent they are taxed at the federal level, after allowing for a foreign tax credit.

A. Description of current practice

State taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. According to the Multistate Tax Commission, dividends from a domestic corporation are subject to tax in 38 states, but most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is to largely exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

B. Description of the problem

As explained above, under the worldwide unitary method, dividends paid from one corporation to another within the unitary business group are eliminated as intercorporate transfers; that is, the respective income of each corporation is combined to determine the taxable income of the unitary group, but intercorporate dividends are ignored. In those states not using the worldwide unitary method, double taxation may be created by state taxation of foreign corporate dividends. This can be viewed as resulting either from the states' incomplete application of the unitary combination principle or of federal tax practice.

Under the worldwide unitary method, both the income and the underlying business activities (usually payroll, property, and sales) of foreign corporations are included in the formula used to determine in-state income. In the case of dividends, however, only the foreign corporate dividends are included in the state apportionment formula. None of the foreign corporation's payroll, property, and sales, that arguably give rise to the income out of which dividends are paid, is included in the formula. The result is state taxation of foreign dividends. Justice Stevens identified this problem in his dissent in Mobil Oil Corporation

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v. Commissioner of Taxes of Vermont. He stated that "unless the sales, payroll, and property values connected with the production of income by the payor corporation are added to the denominator of the apportionment formula, the inclusion of earnings attributable to those corporations in the apportionable tax base will inevitably cause Mobil Vermont's income to be overstated."

Alternatively, the problem can be characterized as grounded in the states' reluctance to allow a foreign tax credit. Under federal rules, dividends from a foreign corporation are included in the U.S. shareholder's taxable income, but a foreign tax credit alleviates double taxation. Many of the states also include these dividends in the tax base, but without a foreign tax credit. Since these dividends likely will have been taxed in the foreign jurisdiction, subjecting them to state taxation can be viewed as double taxation.

Even if double taxation exists, the states disagree that they should be prevented from taxing this dividend income. They contend that the foreign dividends are earned as a result of the management and supervisory activities of the U.S. corporate shareholder. In their view, the dividends are income of the recipient U.S. corporation and are a legitimate part of the state tax base.

C. Federal interest

The federal interest is confined to the alleviation of international double taxation and the facilitation of international trade and investment flows. Since the dividends in question are received by a U.S. corporation, this issue does not raise the foreign policy and international comity issues raised by the worldwide unitary method. Nor can it be said to create an "administrative burden" since these dividends are subject to tax at the federal level.

D. States interest

The states' interest is two-fold: possible revenue loss and freedom to design their own fiscal structure.

E. Policy options

1. Option One: Retain present state practice. This would permit the states to continue to tax dividends received from foreign corporations.

ADVANTAGES

(a) Would give full acknowledgement to state sovereignty argument by not interferring with taxation of foreign corporation dividends.

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(b) Consistent with congressional reluctance to intervene in state taxation. For the past few years, Mathias-Conable legislation to restrict state taxation of foreign dividends has been before the Congress. Neither the House nor Senate, however, has voted on the legislation.

(c) Would protect state tax revenues. Prohibiting states from taxing foreign corporate dividends would cost the states currently taxing these dividends about $280 million annually, according to the Multistate Tax Commission.

DISADVANTAGES

(a) Would fail to eliminate double taxation. The dividends presumably have borne a withholding tax levied at source by the foreign jurisdiction and the income out of which the dividends are paid also has been taxed in the foreign jurisdiction. For the states to tax these dividends represents a clear case of double taxation.

(b) Would fail to correct an obvious excess in state tax systems. Dividends paid by a foreign corporation (which has no business presence in the state) out of income earned in a foreign country should be beyond the pale of a tax system designed to tax in-state income.

(c) Would perpetuate a system of taxation that is in open conflict with the worldwide unitary method, which includes both the foreign corporation's income and its business activities (payroll, property, and sales) in the apportionment formula. The taxpayer is taxed on a portion of its worldwide income related to its in-state business activities. A state taxing foreign dividends on a non-combined basis, however, does not include any of the payor corporation's payroll, property, or sales in its apportionment formula. This amounts to an incomplete application of the unitary business principle, and assures that the dividends paid by the foreign corporation will be subject to state taxation.

2. Option Two: Restrict or prohibit state taxation of foreign dividends. This option would impose federal restrictions on state taxation of foreign corporate dividends. While the restriction could take a number of different forms, the objective would be to curtail sharply state taxation of foreign dividends. One possibility would be to exempt foreign dividends. Alternatively, states might be permitted to tax foreign dividends to the extent they are taxed by the federal government, in effect requiring the states to allow a foreign tax credit. Another possibility would be to require a state to treat foreign dividends the same as domestic dividends. (Illinois recently adopted this approach.)

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State taxation of dividends represents a clearer case of double taxation than does the worldwide unitary method. It also is more politically sensitive because more states tax foreign dividends than use the worldwide unitary method. Since the dividends issue only affects U.S. based multinationals, this option offers a way of mollifying the objections of U.S. business if the unitary method is restricted only for foreign based multinationals. U.S. business, in other words, might still be subject to state taxation on a worldwide unitary basis, but their foreign dividend income would be exempt. Nevertheless, the states would have an important victory; U.S. government ratification of the unitary method as applied to U.S. multinationals.

The advantages and disadvantages are the reverse of option one and, therefore, are not repeated here.

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